

Tax Case Memo to File and Letter to Client

Instructions to Students

When you research a tax question for a client, you write a memo to the file summarizing your research so that people in your firm can access it later if needed. In addition, you write a letter to the client explaining your findings. Thus this assignment gives you a chance to apply what you have learned about tax research and also about writing for different audiences.

Read the tax case and identify the 3-4 issues you would need to tell your client, Mr. Gomez, about. Section 162 of the Regulations and the Allied-Signal case add technical explanation that you will need.

First, you write the memo to the file. A possible outline could include these headings:

- Relevant Facts
- Specific Issues
- Conclusions
- Support
- Actions to be Taken

You will use specific tax law references to back up your findings. First write a direct memo to the file that will provide a record of your findings for your accounting firm. It needs to be clear, detailed but concise, and to cover the relevant issues and findings so that your findings are documented

Then, using your facts and conclusions, write a tactful indirect letter to Mr. Gomez explaining the findings about the deductibility of the fine and the payment to the foundation. For the client, you need to make sure you are explaining accounting concepts and tax law clearly for a non-expert. Defining terms and using examples will help. In the letter, you will explain the tax law, but do not need to use the tax law citations.

In this two-part assignment, use good professional writing style, proofread your documents, and apply what you have learned about direct and indirect messages.

Evaluating outcomes: In the EPA case (negative findings), use the Indirect Case Exam Rubric to evaluate the client letter for reader-centered writing (50% of grade) that is clear, logical, and specific, with conversational writing style. Coverage of important case information is 30%, writing style and proofreading 10%, and memo/letter format 10%. The memo to file can use the Direct Case Exam Rubric (50% Reader-Centered Writing, 30% Coverage of important case information in appropriate order, 10% letter/memo format, 10% style/proofreading).

Tax Case for MIS 390W

Research Case 1

Odiferous Chemical Company manufactured pesticides that were toxic. Over the course of several years, the toxic waste contaminated the air and water around the company's plant. Several employees suffered toxic poisoning, and the Environmental Protection Agency cited the company for violations. In District Court, the judge found Odiferous guilty and imposed fines of \$15 million. The company voluntarily set up a charitable fund for the purpose of bettering the environment and funded it with \$8 million. The company incurred legal expenses in setting up the foundation and defending itself in court. The court reduced the fine from \$15 million to \$7 million. Odiferous Chemical Company deducted the \$8 million paid to the foundation and the legal expenses incurred. The IRS disallowed both deductions on the grounds that the payment was, in fact, a fine and in violation of public policy. Odiferous' president, Ted Gomez, has contacted you regarding the deductibility of the \$7 million fine, the \$8 million payment to the foundation, and the legal fees of \$275,000. Write a letter to Mr. Gomez that contains your advice and prepare a memo for the tax files. Odiferous' address is 1200 Industrial Waste Rd, Phoenix, AZ 85003.

Issue 1

Issue 2

Issue 3

Issue 4

Instructions to Students: Read the tax case and identify the 3-4 issues you would need to tell your client, Mr. Gomez, about. Section 162 of the Regulations and the Allied-Signal case add technical explanation that you will need. First write a direct memo to the file that will provide a record of your findings for your accounting firm. It needs to be clear, detailed but concise, and to cover the relevant issues and findings so that your findings are documented. Then write an indirect letter to Mr. Gomez explaining your findings about the deductibility of the fine and the payment to the foundation. Use good professional writing style, proofread your documents, and apply what you have learned about direct and indirect messages.

SECTION 162. TRADE OR BUSINESS EXPENSES

(a) IN GENERAL

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
- (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
- (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(b) CHARITABLE CONTRIBUTIONS AND GIFTS EXCEPTED

No deduction shall be allowed under Subsection (a) for any contribution or gift which would be allowable as a deduction under Section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such Section.

(c) ILLEGAL BRIBES, KICKBACKS, AND OTHER PAYMENTS

(1) Illegal Payments To Government Officials Or Employees

No deduction shall be allowed under Subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or is unlawful under the Foreign Corrupt Practices Act of 1977) shall be upon the Secretary to the same extent as he bears the burden of proof under Section 7454 (concerning the burden of proof when the issue relates to fraud).

(2) Other Illegal Payments

No deduction shall be allowed under Subsection (a) for any payment other than a payment described in paragraph (1) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under Section 7454 (concerning the burden of proof when the issue relates to fraud).

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(f) FINES AND PENALTIES

No deduction shall be allowed under Subsection (a) for any fine or similar penalty paid to a government for the violation of any law.

REGULATIONS SECTION 1.162-21. FINES AND PENALTIES.

(a) IN GENERAL. No deduction shall be allowed under Section 162(a) for any fine or similar penalty paid to--

- (1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;
- (2) The government of a foreign country; or
- (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.

(b) DEFINITION.

(1) For purposes of this section a fine or similar penalty includes an amount--

- (i) Paid pursuant to conviction or a plea of guilty or NOLO CONTENDERE for a crime (felony or misdemeanor) in a criminal proceeding;

- (ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;
- (iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or
- (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

(2) The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under Section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Allied-Signal, Inc. v. Commissioner, T.C. Memo. 1992-204

Allied-Signal, Inc. (Allied), is successor-in-interest by merger to Allied Corporation, formerly known as Allied Chemical Corporation. During the years 1977 through 1982, Allied was in the business of researching, developing, manufacturing, and selling agricultural and industrial chemicals. In the late 1940s and early 1950s, Allied Chemical developed a highly toxic chemical pesticide known as Kepone. Allied marketed Kepone primarily in Europe as an insecticide in potato farming. It also sold a small percentage of Kepone in Central America for use in banana groves and in the United States for use in ant traps. Kepone was manufactured from the late 1950s through July 1975. In March 1974, another company under contract with Allied began manufacturing Kepone. In July 1975, the Virginia State Department of Health ordered the company to cease operations after being alerted to Kepone poisoning of as many as 62 of the company's employees. The Kepone poisoning occurred because the company failed to follow or ignored safety precautions in manufacturing Kepone. The company was rendered insolvent when its plant was closed. Portions of the James River and Chesapeake Bay were closed to fishing as a result of the incident, which the local and national press blamed on Allied.

Allied was indicted by a grand jury in 1976 on 940 counts of unlawful discharge of Kepone and other contaminants occurring between 1971 and 1974. Allied also was indicted for aiding and abetting the contract company in unlawful discharges of Kepone. Allied pleaded nolo contendere to the charges in the first indictment, over the objections of the U.S. Attorney. The judge sentenced Allied to pay the maximum fine on all counts, totaling \$ 13.2 million. The sentencing judge informed Allied that he would entertain a motion to reduce the fines and might take into account any voluntary action taken by Allied to mitigate the effects of the Kepone incident.

After conferring with its tax counsel and several law firms, Allied established the 'Virginia Environmental Endowment Fund' to alleviate the effects of Kepone on the environment. Creation of the endowment was undertaken, at least in part, to counter adverse publicity received by Allied as a result of the Kepone incident. Allied transferred \$ 8 million to the endowment, which was structured as a Section 501(c)(4) organization. The sentencing judge reduced Allied's fine to \$ 5 million. Allied claimed its payments to the endowment was a business expense under Section 162(a). Allied also deducted \$ 49,323 in legal fees connected with organizing the endowment. The IRS disallowed the deductions, determining that the payments were nondeductible as fines or similar penalties under Section

162(f).

Tax Court Judge Parker has held that the \$ 8 million payment to the endowment is nondeductible under Section 162(f). Judge Parker found that Allied 'made the \$ 8 million payment to the Endowment with the virtual guarantee that the sentencing judge would reduce the criminal fine by at least that amount. [Allied's] characterization of this payment as 'voluntary' is simply not borne out by the record as a whole.' Judge Parker found it clear that the payment was made to mitigate Allied's criminal sentence. The court rejected Allied's argument that the payment was not a fine or penalty because it did not serve to punish or deter, concluding that the payment served a law enforcement, not a compensatory purpose, citing *Waldman v. Commissioner*, 88 T.C. 1384 (1987).

In conclusion, the court held that the legal fees related to the endowment were 'incurred in the defense of a prosecution' and were thus deductible as ordinary and necessary business expenses under Section 162(a).

EFFECTIVE COMMUNICATION SLIDES

Effective Communication

- Put the audience first (reader-centered writing)
- Use words audience will understand
- Organize effectively for purpose
- Revise and edit for conventional usage
- Reduce writing time

Overall Strategies

- Put the main idea up front if it is positive
- Don't give the reader *too much* information
- Concentrate on one or two subjects
- Use emphasis and subordination
- Define your terms
- Use examples to explain

Audience Analysis

- Who are you writing to? Relationship (boss, peer, employee, etc.)? More than one person? Decision-maker?
- What does this person need to know? Does he/she understand accounting terms?
- What action do you want the audience to take? How can you encourage it?

Direct Case Exam Rubric

50 Reader-centered writing

You attitude/audience-centered
Clear explanation
Logical discussion
Specifics to “show” points rather than general statements
Uses pronouns, active voice for positive ideas
Conversational writing style
Does NOT copy case wording

30 Coverage of important case information in appropriate order

Direct message protocols
 Begins with purpose statement
 Uses active voice
 Responds to prompt with specifics/relevant details
 Provides possible solution/s/
 Ends with request or recommendation for action/pleasant closing
Little extraneous explanation or information (does not overexplain)
Order of material in case not the same as appropriate for explanation – logical order
Avoids negative words, uses passive voice only for negative ideas
Gets action at end if appropriate
Provides sense of closure at the end if no action
Use of emphasis and subordination
 Descriptive headings
 Subordinate clauses
 Transitions between paragraphs
 Useful paragraph divisions

10 Correct letter/memo format

10 Style/Proofreading

Avoids fatal errors by using correct punctuation, capitalization, spelling (minus 1 for each fatal error)
Correct syntax, diction
Professional language and appearance

Total Points/Comments

Indirect Case Exam Rubric

50 Reader-centered writing

You attitude/audience-centered; buffer/attention, not purpose in opening paragraph
Clear explanation
Logical discussion
Specifics to “show” points rather than general statements
Uses passive voice to subordinate negative ideas
Avoids negative words
Conversational writing style

30 Coverage of important case information using correct indirect protocols

Negative: Buffer, Appropriate details, Problem addressed w/o assigning blame, little extraneous explanation or information (does not overexplain), Order of information appropriate for explanation, provides appropriate solution/explanation, provides sense of closure at the end if no action, ends on positive note

Persuasive: Attention and interest in para 1, several para of conviction, appropriate action at end in last para, with final reminder of positive

Use of emphasis and subordination

Subject line does not reveal negative
Appropriate/descriptive headings

10 Writing Style and Proofreading

Correct syntax, diction
Subordinate clauses
Transitions between paragraphs
Useful paragraph divisions
Professional language and appearance
Avoids fatal errors by using correct punctuation, capitalization, spelling (minus 1 for each fatal error)

10 Correct letter/memo format

Addresses, date, salutation, and closing if letter
Headings, emphasis, no signature if memo

Total Points/Comments

Client Letter Example

**Smith and Jones, CPAs
San Diego, CA
December 2, 2013**

Dr. David Dental and Dr. Sally Surgeon
678 Chic Way
La Jolla, CA 92037

Dear David and Sally:

Congratulations on the purchase of your new home! Thank you again for requesting my advice concerning the tax treatment of your home mortgage interest. I understand that you each took out a separate \$800,000 mortgage to acquire your new home in La Jolla. I am sorry to report that only a portion of your interest on the mortgages can be deducted this year.

My research has uncovered a section of tax law that limits the amount of interest that can be deducted for loans taken out for personal reasons. My efforts have concentrated on the treatment of interest expenses for separate home mortgages taken out by unmarried individuals.

Although your mortgage qualifies for a deduction, the tax law limits the amount of debt that can be used to calculate an interest deduction to \$1,000,000 for one property. Your home's total mortgage of \$1.6 million exceeds this amount. Because you are not married, but you both own the property equally, your interest deduction will be limited to a proportion of the debt on the property.

My conclusion is based on the facts that you have provided me, and upon the reliability of the Chief Counsel Advice's interpretation of the Internal Revenue Code. As you've requested, I've attached a copy of my research memo. Let me know if after reading the memo you have developed more questions.

I'm sorry that the news from me wasn't more favorable. I look forward to seeing you, though, at the firm's New Year's Eve Ball!

Sincerely,
Joy Smith
for Smith and Jones, CPAs

Memo to File Example

**Smith and Jones, CPAs
San Diego, CA
December 2, 2009**

Relevant Facts

David Dental, DDS and his unmarried partner Sally Surgeon, MD live in California. They bought a home together during 2009 for two million dollars. They put a 20% down payment of \$400,000 and financed the balance of \$1,600,000. Dr. Surgeon and Dr. Dental each took out a separate mortgage for \$800,000. There is no other debt on the residence.

Specific Issues

How much of the mortgage interest paid can be claimed as an itemized deduction by David Dental and Sally Surgeon?

Conclusions

Dr. Dental and Dr. Surgeon are each allowed a deduction of a portion of their respective interest. The combined amount of debt on the property that can qualify for an interest deduction is limited to \$1,000,000.

Support

The Code allows a deduction on qualified residence interest. Qualified residence interest includes interest on "acquisition indebtedness with respect to any qualified residence of the taxpayer." IRC § 163(h)(3). Acquisition indebtedness is defined as debt that is incurred in acquiring a qualified residence and is secured by the residence. A qualified residence is the main residence of the taxpayer in which the taxpayer actually resides. IRC § 163(h)(4)(A). The amount of a mortgage that can be treated as acquisition indebtedness is limited to \$1,000,000 for an individual and \$500,000 for married taxpayers filing separately. IRC § 163(h)(3)(B)(ii). Unmarried individuals that purchase a home together are not directly addressed in the Code section.

Although it cannot be used as precedent, Chief Counsel Advice 200911007 gives guidance on a similar situation. The Chief Counsel advises that acquisition indebtedness is incurred in acquiring a qualified residence and not just a portion of that residence. The \$1,000,000 limitation is therefore interpreted as being a limitation of "total, 'aggregate' acquisition indebtedness" for the property. In this case, the amount of interest that is qualified for a deduction is determined by "multiplying the amount of interest paid by Taxpayer...by a fraction: \$1,000,000 over the amount of Mortgage."

The total aggregate mortgage on Dr. Dental and Dr. Surgeon's qualified residence, at \$1,600,000, is over the \$1,000,000 limit. The taxpayers will each be able to deduct 50% of the qualified interest.

Actions to Be Taken

- _____ Discuss with client. Date discussed _____
- _____ Prepare a memo or letter to the client
- _____ Explore other fact situations
- _____ Other action. Describe: Place copy of mortgage deeds in client file.

Preparer Joy Smith Reviewer Lynn Jones Partner Dr. Gretchen Vik

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